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No. 94-18

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# In the Supreme Court of the United States

OCTOBER TERM, 1994

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ANTONIO C. MASTROBUONO, ET AL.,

PETITIONERS,

v.

SHEARSON LEHMAN HUTTON, INC., ET AL.,

RESPONDENTS.

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**On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit**

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## BRIEF FOR THE SECURITIES INDUSTRY ASSOCIATION AS AMICUS CURIAE SUPPORTING RESPONDENTS

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## QUESTION PRESENTED

Whether the contract between petitioners and respondent Shearson Lehman Hutton precluded the arbitrators from awarding punitive damages.

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## BRIEF FOR THE SECURITIES INDUSTRY ASSOCIATION AS AMICUS CURIAE SUPPORTING RESPONDENTS

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## INTEREST OF THE AMICUS CURIAE

The Securities Industry Association (SIA) is the principal trade association of the securities industry, with more than 750 member firms in the United States and Canada. As a member of the Securities Industry Conference on Arbitration, the SIA has been intimately involved in the evolution of the

arbitration process. That process began in the securities industry as far back as 1872, when the New York Stock Exchange began using alternate means of resolving disputes. From the time of that rudimentary beginning to today's substantial arbitration system, which disposes of more than five thousand claims annually, the securities industry has been a pioneer in the use of arbitration to resolve disputes quickly, fairly, efficiently, and economically.

This case brings before the Court an important question about arbitration. The arbitration agreements between securities firms and their customers frequently contain a choice-of-law clause; different agreements reference the laws of different States. The industry contends, and numerous courts — including the courts below — have agreed, that clauses referencing New York law incorporate into the agreement the rule of *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976), which held that arbitrators may not award punitive damages. Petitioners argue that this provision of the agreement is preempted by the Federal Arbitration Act or unenforceable for various other reasons.

Because the SIA's members have a significant interest in ensuring that their arbitration contracts are enforced according to their terms, the Association tenders this amicus brief to assist the Court in its consideration of this case. The SIA has participated as amicus curiae in other cases involving issues arising in securities industry arbitrations, including *Dean Witter Reynolds Inc.* v. *Byrd*, 470 U.S. 213 (1985); *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220 (1987); and *Rodriguez de Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

## STATEMENT

The arbitration proceeding giving rise to this case was one of literally thousands of arbitrations that take place each year pursuant to agreements between securities firms and their customers. In 1993, for example, 6,561 cases were



received by the organizations principally involved in connection with arbitration of securities disputes. *Securities Industry Conference on Arbitration Report #8* 29 (June 1994). That represents a nearly fourfold increase over the number of cases received in 1983. *Ibid.*

A total of 5,363 cases were resolved in 1993; of those, 1,617 were decided on the merits and the remainder were settled. *Securities Industry Conference on Arbitration Report # 8*, *supra*, at 29. The increase in resolutions from 1983 to 1993 more than exceeded the increase in cases received, indicating that the arbitration fora have succeeded in keeping pace with the tremendous increase in demand for their services.

Moreover, recent analyses of the results of these arbitrations confirm the general fairness of the process: outcomes are closely divided between claimants and securities firms, with claimants winning a slightly higher percentage of the cases. Thus, the General Accounting Office found that investors prevail in 59% of the cases that they file. General Accounting Office, *Securities Arbitration — How Investors Fare* 35 (May 1992). The arbitration process also is comparatively expeditious. The GAO Study found (*id.* at 43) that securities disputes were resolved, on average, in a little over one year when arbitrated through the securities industry self-regulatory organizations (SROs) — the national exchanges and registered securities association endowed with statutory authority to regulate the securities industry (see 15 U.S.C. §§ 78f, 78*o*-3 & 78s) — whereas cases litigated in the court system took considerably longer (*id.* at 49).

Although the use of arbitration as an alternative to the judicial system dates back to practices instituted by the New York Stock Exchange in 1872, the arbitration process has evolved considerably since that time. The SROs have adopted rules governing arbitration. These rules establish procedures governing, for example, filing of a claim,

selection of arbitrators, pre-hearing discovery, the hearing, and entry of the arbitrators' decision. See generally NASD Code of Arbitration Procedure §§ 14-45. The SROs also regulate the terms of the agreement between the customer and the securities firm. See, *e.g.*, NASD Rule of Fair Practice 21(f)(1) & (2) (requiring that predispute arbitration clauses contained in post-September 1989 customer agreements "be highlighted" and disclose specified information regarding the arbitration process). Moreover, the SEC is endowed with plenary authority over SRO rules. 15 U.S.C. § 78s(b) & (c).

Some of the contracts between securities firms and their customers contain a clause similar to the one at issue here, which provides in pertinent part:

> This agreement * * * shall be governed by the laws of the State of New York. * * * [A]ny controversy arising out of or relating to [the petitioners'] accounts * * * shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as [petitioners] may elect.

Pet. App. 44.[1]

The district court concluded that this provision constituted an agreement by the parties to bar awards of punitive damages in arbitration (at least unless and until New York law changes). It found that "a customer of a brokerage firm who signs an agreement expressly governed by New York law" has agreed that punitive damages will not be available in arbitration because — under the holding of *Garrity* v. *Lyle*

[1] The selection of New York law is by no means uniform across the securities industry. Other contracts, especially those of regional securities firms, reference the law of other States.



*Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976) — New York law bars arbitrators from awarding punitive damages. Pet. App. 31, 33.

The court of appeals agreed. It stated that "the parties agreed to arbitrate all of their controversies under New York law. By choosing New York law without excluding its arbitration rules, the parties adopted *Garrity* as a binding rule." Pet. App. 12. "Given our conclusion that the parties wished to arbitrate all of their disputes subject to *Garrity*, there is no need to consider whether the *Garrity* rule is preempted by the [Federal Arbitration Act] or by the federal common law 'govern[ing] the construction of arbitration agreements.'" *Id.* at 20 (citation omitted).

## SUMMARY OF ARGUMENT

The questions before the Court in this case are in the first instance issues of state law. "The preeminent concern of Congress in passing the [Federal Arbitration] Act was to enforce private agreements into which parties had entered." *Dean Witter Reynolds, Inc.* v. *Byrd*, 470 U.S. 213, 221 (1985). The courts below concluded that the arbitration agreement's choice-of-law provision referencing New York law incorporates the *Garrity* rule barring the imposition of punishment by arbitrators. Because the parties agreed to that provision, it is binding under the Arbitration Act.

Petitioners contend that the parties' agreement should be invalidated for several reasons, all of which are meritless. They claim, for example, that availability of punitive damages provides needed deterrence of misconduct; but that contention is utterly unfounded, because existing SRO disciplinary systems ensure that any wrongdoing brought to light in arbitration will be scrutinized by expert regulators and punished when appropriate. If anything, the injection of uncontrolled punitive damages into the arbitration process will distort and undermine the comprehensive SRO disciplinary mechanisms. As for petitioners' claim that the arbitration

agreement is unconscionable, it rests on the very contentions rejected by this Court when it upheld the arbitrability of federal securities claims in *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 223-224 (1987).

Subjecting a party to liability for punitive damages in arbitration against his or her will, on the other hand, would raise concerns of fundamental fairness and constitutional due process. To the extent petitioners and their amici contend that the arbitrators are entitled to administer punishment despite the parties' contrary agreement, whether through preemption under the FAA or by operation of the SRO rules that respondent must obey under compulsion of federal law, the arbitration standards would have to satisfy due process.

This Court's decisions in *Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331, 2340 (1994), and *Pacific Mutual Life Insurance Co.* v. *Haslip*, 499 U.S. 1 (1991), establish that specific procedural protections — including, most importantly, independent review of any punitive award by a court or, perhaps, a separate appellate tribunal within the arbitration process — are essential prerequisites for a constitutional punishment regime. Because the current securities arbitration system includes no such protections, the unconsented injection of punitive damages exposure would be unconstitutional.

Finally, the government solicits an advisory opinion from the Court stating that NASD Rule 21(f)(4), which it acknowledges is inapplicable to the customer agreement here, would, where applicable, preclude enforcement of choice-of-law provisions that have the effect of barring arbitrators from imposing punitive damages. The government suggests that the meaning of the rule is so obvious that the Court should save itself the trouble of waiting to decide the question until some future case in which it actually is presented. In fact, however, it is the government's construction that is manifestly in error. The language of the rule, informed by the relevant



rulemaking history, leaves no doubt that the rule was not intended to restrict the operation of choice-of-law clauses.

## ARGUMENT

### PETITIONERS MAY NOT RECOVER PUNITIVE DAMAGES IN THE ARBITRATION PROCEEDING

#### A. The Courts Below Correctly Interpreted The Parties' Agreement As Incorporating The *Garrity* Rule.

Section 4 of the Federal Arbitration Act (FAA), 9 U.S.C. § 4, empowers the district courts to direct parties "to proceed to arbitration in accordance with the terms of the agreement." Thus, "the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." *Volt Information Sciences, Inc.* v. *Board of Trustees*, 489 U.S. 468, 476 (1989). See also *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 625 (1985) (the policy of the FAA "is at bottom a policy guaranteeing the enforcement of private contractual arrangements"); *Dean Witter Reynolds Inc.* v. *Byrd*, 470 U.S. 213, 221 (1985) ("[t]he preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered").

The critical — and dispositive — question in this case accordingly is whether the parties agreed that punitive damages would not be available if they had a dispute that went to arbitration. Both courts below concluded that by expressly choosing New York law to govern the agreement, the parties incorporated the rule of *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976), which holds that arbitrators may not award punitive damages.

This Court faced a virtually identical issue in *Volt*. The agreement there provided that "[t]he contract would be governed by the law of the place where the project is located," and the lower courts held that this choice-of-law

clause incorporated California rules of arbitration into the parties' agreement. 489 U.S. at 470, 472 (internal quotations omitted). The lower courts therefore ordered the arbitration stayed under a provision of California law authorizing a court to stay an arbitration pending the resolution of related litigation between a party to the arbitration agreement and third parties not bound by the agreement. *Id.* at 472.

Observing that "the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review," this Court declined to revisit the lower courts' determination that "by incorporating the California rules of arbitration into their agreement, the parties had agreed that arbitration would not proceed in situations which fell within the scope of" the state law stay provision. 489 U.S. at 474, 475. That same conclusion is appropriate here.

As in *Volt*, the lower courts' construction of the contract rests on their interpretation of state contract law. Accord, *Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991) (holding that the choice-of-law clause incorporates the *Garrity* rule). There simply is no reason for this Court to revisit that issue.

Moreover, again as in *Volt*, the principle that, in applying state-law rules of contract interpretation, "questions of arbitrability * * * [are to] be addressed with a healthy regard for the federal policy favoring arbitration" (489 U.S. at 475) affords no basis for setting aside the lower courts' construction of the contract. To begin with, this Court has utilized that principle only in determining whether a particular cause of action is arbitrable. See, *e.g.*, *Moses H. Cone Memorial Hospital* v. *Mercury Construction Corp.*, 460 U.S. 1 (1983). The federal policy favoring arbitration is implicated in that context because of the risk that an ambiguous contract provision could be misinterpreted and a cause of action erroneously found nonarbitrable.



When, by contrast, the question involves not the availability of arbitration but simply the standards governing the arbitration proceeding — procedures, available remedies, and the like — the Court has not invoked this federal principle of interpretation. That is because, as the Court put it in *Volt*, "[t]here is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." 489 U.S. at 476. In other words, although the FAA embodies a preference for erring on the side of overinclusiveness in determining what causes of action are subject to arbitration, the statute simply does not prefer one set of arbitration standards over another. That issue is left entirely to the parties' agreement, as construed pursuant to governing state law principles.

The government attempts (Br. 21-23) to inject the *Cone* principle into this case on two grounds, neither of which withstands scrutiny. First, it recites the truism that by agreeing to arbitrate a claim, a party does not forego the substantive rights associated with that claim. Here, of course, petitioners did more than simply agree to arbitrate; they also agreed to the application of New York law. That selection of a particular State's law may, among other things, impact upon the circumstances in which relief is available under the agreement. Surely the FAA allows parties to an arbitration agreement to make such a choice.

If the government means to assert that *Cone*'s interpretative principle extends to construing any contractual restriction on the arbitrator's authority, it is equally mistaken. *Volt* upheld a significant limitation on arbitration that, as the dissenters observed (489 U.S. at 487), effectively vitiated the right to arbitration. Even though the stay of arbitration overrode the provisions of the FAA itself, the Court held the *Cone* principle inapplicable and enforced the parties' agreement:

> [w]here, as here, the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward.

489 U.S. at 479. To the extent the government's *Cone* derived "unambiguous intent" standard (see Br. 23) would override the parties' choice of state law here, it is squarely inconsistent with *Volt*. The Court there limited the arbitrator's authority based on the very same manifestation of the parties' intent relied upon by the courts below in this case — the contract's choice-of-law clause.

Second, the government asserts (Br. 22-23) that the courts below were wrong to hold that the New York choice-of-law provision incorporates *Garrity* because that decision allegedly rests on "mistrust of arbitrators." But the wisdom of and basis for the policy underlying *Garrity* is irrelevant because that rule does not apply here of its own force; it applies because the parties chose to abide by New York law. Moreover, as we discuss below (at 15-17), the government's characterization of *Garrity* is wrong.[2]

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[2] The government states (Br. 23) that "[t]he necessary consequence of the *Garrity* rule * * * is that execution of an arbitration agreement entails not simply consent to an alternative forum, but a waiver of substantive rights as well." While that observation might have some relevance in a case in which the arbitration agreement was silent or expressly provided for punitive damages awards, it is wholly inapposite here, where *Garrity* applies not because the parties executed an arbitration agreement, but rather because *the parties expressly chose to be bound by New York law*.



The *Cone* principle is inapplicable here for the additional reason that the contract is not ambiguous. The lower courts' construction of the choice-of-law clause is the same one adopted by the lower courts in *Volt*: a choice-of-law clause incorporates the state law rules governing arbitration. As the Second Circuit put it, a contract such as the one here is "clear" on that point. *Barbier*, 948 F.2d at 122.

The only possible question is whether the reference in the contract to the arbitration rules of the NASD and other SROs introduces any ambiguity into the equation. All of these rules are silent with respect to the availability of punitive damages. What they mean, we believe, is simply that the arbitrator has such powers as may be conferred by the contract. NASD Code of Arbitration Procedure § 12(a) (dispute "shall be arbitrated as provided by any duly executed and enforceable written agreement"). Accordingly, whatever the appropriate default rule might be when the contract is silent (compare *Fahnestock Co.* v. *Waltman*, 915 F.2d 512, 519 (2d Cir.) (punitive damages barred), cert. denied, 112 S. Ct. 389 (1991), with *Baravati* v. *Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 710 (7th Cir. 1994) (punitive damages allowed where there is no choice-of-law clause)), the default principle has no application to the situation in which, as here, the contract resolves the point.[3]

Petitioners argue this case (see Br. 17-58) as if the contract stated "punitive damages may be awarded in arbitra-

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[3] The court below observed (Pet. App. 15) that the NASD Arbitration Manual states that the issue of punitive damages "may" arise and arbitrators "can" consider that remedy. To begin with, the agreement refers to the NASD "rules" — the NASD Rules of Fair Practice and Code of Arbitration Procedure — not to the Manual. Moreover, the Manual does not state that punitive damages are *always* available. Rather, it recognizes that arbitrators "can" consider them — which we do not dispute, *if* the arbitration agreement allows that remedy.

tion" and the question before the Court was whether the FAA preempted the application of *Garrity* to thwart the will of the parties. But the contract said nothing of the sort; rather, it explicitly selected New York law, meaning, as discussed above, that the parties *agreed* to be bound by *Garrity*. Far from being in a position to invoke the FAA to avoid that agreement, petitioners are confounded by the FAA's policy of enforcing arbitration agreements.[4]

* * * *

In addition to addressing the questions presented in this case regarding the meaning and enforceability of the choice-of-law provision contained in the arbitration agreement, the government raises an argument not presented in the petition, contending (Br. 12-19) that the arbitrators' determination that the agreement authorized punitive damages is not subject to de novo review under Section 10 of the Federal Arbitration Act, 9 U.S.C. § 10. The SIA agrees with respondents that — for the reasons stated in their brief — the de novo review standard applies here.

### B. Relevant Policy Considerations Weigh Sharply Against Construing The Contract To Allow Awards Of Punitive Damages In Arbitration.

Petitioners and their amici advance a number of policy arguments in support of their contention that punitive damages should be available in cases such as this one. Although, as we have discussed, we believe that this case is controlled by the parties' agreement and not general policy considerations, we cannot fail to respond to these arguments.

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[4] The government's musings (Br. 26-27) about how the issue might be resolved if there were no choice-of-law provision in the contract are entirely irrelevant: the contract before the Court *does* contain such a provision, and the critical question here is the meaning of *that* contract, as the government itself recognizes (*id.* at 12, 20-25).



In fact, the relevant policy considerations fully support the court of appeals' construction of the contract.

### 1. Permitting Awards Of Punitive Damages Would Substantially Vitiate The Considerable Practical Benefits Of Securities Arbitration.

A principal attraction of the arbitration process is its speed and procedural simplicity, and therefore lower cost, in comparison to the civil litigation system. "[I]t is often a judgment that streamlined proceedings and expeditious results will best serve their needs that causes parties to agree to arbitrate their disputes; it is typically a desire to keep the effort and expense required to resolve a dispute within manageable bounds that prompts them mutually to forgo access to judicial remedies." *Mitsubishi Motors Corp.*, 473 U.S. at 633.

Securities arbitrations are far from summary proceedings, but they remain much more informal than civil litigation. Procedural and evidentiary rules are relaxed; only focused discovery is permitted; claimants are often able to present their cases without having to retain legal counsel; and arbitrators are not required to provide reasons for their decisions. NASD Code of Arbitration Procedure §§ 32, 34, 41.

Injecting punitive damages into this system would alter it in two significant respects. First, the stakes in each individual arbitration would change dramatically. Unlike the potential magnitude of compensatory damages, which usually can be estimated with some certainty, punitive damages are by their very nature uncertain. The increase in monetary stakes that would result from the addition of the "wild card" of a possible huge punitive damages award would impel defendants and claimants to devote more resources to the arbitration process. That would increase the parties' costs and prolong the process, significantly diminishing the value

of arbitration as an efficient and speedy means of settling disputes.[5]

Second, simple fairness — and likely due process requirements as well (see pages 28-31, *infra*) — would necessitate significant changes if punitive damages are broadly available in arbitration. Indeed, although petitioners and their amici attempt to paint the result in *Garrity* as resting on mistrust of arbitrators, it is in fact a decision grounded in the New York court's concern that allowing awards of punitive damages in arbitration would violate fundamental principles of fairness.

It is by now well settled that limits on the discretion of a decisionmaker awarding punitive damages are essential to prevent unfair results. "One must concede that unlimited jury discretion -- or unlimited judicial discretion for that matter — in the fixing of punitive damages may invite extreme results that jar one's constitutional sensibilities." *Pacific Mutual Life Insurance Co.* v. *Haslip*, 499 U.S. 1, 18 (1991).[6] Just last

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[5] Amicus Public Investors Arbitration Bar Association (PIABA) suggests (Br. 13) that the threat of punitive damages gives defendants an increased incentive to enter into settlements. Unfortunately, that threat operates against innocent defendants as well as guilty ones. Especially in view of the absence of procedural protections in the arbitration process, innocent parties may be forced to settle out of fear of unjustified liability. In the arbitration context, "[t]he additional incentive to settlement provided by [the threat of punitive damages] comes at too high a price in unfairness." *McDermott, Inc.* v. *AmClyde*, 114 S. Ct. 1461, 1469 (1994). Moreover, it takes two to settle, and any intimidation effect on defendants is bound to be effectively neutralized by the increase in the size of settlement demands coming from plaintiffs who see the prospect of a punitive damages bonanza.

[6] See also *id.* at 37 (Scalia, J., concurring) ("I can conceive of no test relating to 'fairness' in the abstract that would approve [the common law] procedure for awarding punitive damages"); *id.* at 42 (Kennedy, J., concurring) ("[w]ere we sitting as state-court judges,



Term, in *Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331, 2340 (1994), the Court held that due process requires judicial review of the size of punitive damages exactions, noting that they pose "an acute danger of arbitrary deprivation of property."

The *Garrity* court observed that "'[w]here punitive damages have been allowed for those torts which are still regarded somewhat as public penal wrongs as well as actionable private wrongs, they have had rather close judicial supervision.'" 353 N.E.2d at 796 (citation omitted). See also *id.* at 797 ("[u]nder common-law principles, there is eventual supervision of jury awards of punitive damages, in the singularly rare cases where it is permitted, by the trial court's power to change awards and by the Appellate Division's power to modify such awards").

The court's objection to the imposition of punitive damages by arbitrators was that "'[i]f the usual rules were followed there would be no effective judicial supervision over punitive awards in arbitration,'" because of the very deferential judicial review of arbitrator's awards. *Garrity*, 353 N.E.2d at 796 (citation omitted). "It would mean that the scope of determination by arbitrators, by the license to award punitive damages, would be both unpredictable and uncon-

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the size and recurring unpredictability of punitive damages awards might be a convincing argument to reconsider those rules or to urge a reexamination by the legislative authority"); *ibid.* (O'Connor, J., concurring) ("[i]mposed indiscriminately, * * * [punitive damages] have a devastating potential for harm. Regrettably, common law procedures for awarding punitive damages fall into [that] category"); *Gertz* v. *Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) ("In most jurisdictions jury discretion over the amounts [of punitive damages] awarded is limited only by the gentle rule that they not be excessive. Consequently, juries assess punitive damages in wholly unpredictable amounts bearing no necessary relation to the actual harm caused").

trollable." *Ibid.* That would amount to "'an unlimited draft upon judicial power'" because the courts would be obliged to enforce these "penal sanctions." *Ibid.* (citation omitted).

Indeed, arbitration closely resembles the jury system in significant respects. Securities arbitrators are not required to have a legal background and, in all cases involving disputes with customers, the majority of an arbitration panel must be composed of members of the general public. NASD Code of Arbitration Procedure § 19. Like juries, moreover, arbitration panels need not explain their determinations.

And the threat of unpredictable arbitral awards of punitive damages is not an empty one. One study found that the average arbitral punitive award in the first six months of 1992 was more than double the average for the prior six months. 5 *Securities Arbitration Commentator*, Chart D (May 1993). Indeed, despite the ongoing dispute about the availability of punitive damages, arbitrators are imposing substantial penalties in a number of cases.[7]

A decision broadly empowering arbitrators to impose punitive damages would therefore require, at a minimum, creation of a separate appellate tribunal to review punitive awards imposed by arbitration panels or, alternatively, provision for substantive judicial review of arbitral punishments. And, in order that review could be meaningful, arbitrators would have to memorialize in writing the grounds for their punitive damages decision. These changes by themselves would obviously have a dramatic impact on the efficiency — and the cost — of the arbitration process.

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[7] See, *e.g.*, *Gage* v. *CIGNA Sec., Inc.*, No. 90-01371 (NASD Mar. 10, 1992) ($3.5 million); *Hickman* v. *PaineWebber, Inc.*, No. 90-03354 (NASD Sept. 9, 1992) ($1.7 million); *Harper* v. *Shearson Lehman Bros., Inc.*, No. 91-00508 (NASD Mar. 26, 1992) ($1 million); *Robertson* v. *Prudential Bache*, No. 33 136 00114 92 00 (AAA July 26, 1993) ($700,000).



Moreover, the SROs would have to give careful consideration to incorporating other procedural protections that courts and legislatures have found appropriate to ensure fairness in the punishment decision. Indeed, given the purposes of punitive damages, the stigma that may be suffered by a defendant found to have committed the kind of outrageous acts that warrant punitive damages, and the importance to the industry as a whole that punishments be rational in amount and generally consistent from one case to another, procedural protections equivalent to those available in the disciplinary process would be appropriate. These additional protections — clear, detailed standards to guide arbitration panels in the initial decision whether to award punitive damages, a heightened burden of proof, and some form of guidelines to be employed in setting the amount of punishment that is appropriate in various circumstances — would also increase the complexity and cost of the arbitration proceeding.

Changes of this nature, however essential to a fair punishment regime, would to a large extent vitiate the benefits of simplicity and speed that prompted creation of the arbitration process in the first place. Moreover, as we next discuss, these very substantial impairments of the arbitration process would yield no countervailing benefits, because the purposes of punishment and deterrence are already served by the existing disciplinary process.

### 2. In View Of The Pervasive Regulatory Oversight Of The Securities Industry, Arbitral Punishment Is Not Necessary To Deter Securities Violations.

Amicus PIABA contends (Br. 13-22) that availability of punitive damages is necessary to deter misconduct by securities firms. That is entirely wrong. The existing SRO disciplinary systems, supplemented by federal and state governmental oversight of the securities industry, already

ensure that any wrongdoing brought to light in arbitration will be scrutinized by expert regulators and that penalties sufficient to punish and deter misconduct will be imposed when appropriate. The injection of punitive damages into securities arbitrations will, if anything, jeopardize the effectiveness of these thorough and carefully calibrated disciplinary mechanisms.

All securities firms and their employees are subject to comprehensive regulation by a statutory self-regulatory organization — the National Association of Securities Dealers ("NASD"). See 15 U.S.C. § 78*o*(b)(8) (requiring all broker-dealers with retail customers to belong to a national securities association registered with the SEC; the NASD is the only such association). The federal securities laws and regulations, the NASD By-Laws, and the NASD Rules of Fair Practice establish a comprehensive code of conduct governing every aspect of the business of member firms.[8] The task of ensuring compliance with these standards — and imposing appropriate disciplinary sanctions for violations — is entrusted in the first instance to the District Business Conduct Committees (DBCCs), which are located in each of the NASD's 11 districts, and the Market Surveillance Committee (MSC), a central committee responsible for reviewing alleged violations of market-related rules.

There simply is no realistic danger that a claim of wrongdoing lodged against an NASD member would escape the attention of these disciplinary committees. There are a variety of means by which the disciplinary process could be triggered:

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[8] See, *e.g.*, 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; NASD Rules of Fair Practice Art. III, § 1 ("[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade"); see generally *id.* Art. III.



- "[a]ny person" who feels aggrieved by an act of a member or person associated with a member may file a complaint with a DBCC;[9]
- arbitrators may refer a matter for disciplinary investigation if they have "reason to believe [there has been conduct that] may constitute a violation of the [NASD] rules or the federal securities laws";[10]
- NASD members and associated persons must report most allegations of misconduct to the Central Registration Depository, and the NASD regularly monitors these reports;[11]
- evidence of misconduct may be detected in the course of the regular examination of an NASD member or the NASD's ongoing market surveillance program.[12]

Sanctions for violations include fines, suspension, expulsion from the securities industry, restitution, or any other appropriate measure. NASD Notice to Members 93-32 (May 1993). And the NASD's decisions are reviewed by the SEC. 15 U.S.C. § 78s. The Securities and Exchange Commission has recognized the effectiveness of the program. See, *e.g.*, SEC, *Annual Report - 1990* 42 (the NASD "operates an effective and thorough [disciplinary] program").

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[9] NASD Rules of Fair Practice Art. IV, § 2.

[10] NASD Code of Arbitration Procedure, § 5.

[11] NASD By-Laws Art. IV & Schedule C.

[12] NASD Rules of Fair Practice Art. IV, § 3; see also NASD, Disciplinary Procedures 6, 12-13 (1990).

Moreover, the conduct of member firms and associated persons is also regulated by the relevant government agencies. The SEC has its own authority to discipline broker-dealers for violations of federal law and regulations (15 U.S.C. § 78*o*); it may institute enforcement proceedings seeking civil monetary penalties (15 U.S.C. § 78u-2); and it may refer matters to the Department of Justice for criminal prosecution (15 U.S.C. §§ 78u, 78u-1, 78ff). State regulators have similar oversight authority.[13]

The private disputes adjudicated in the SRO arbitration system are thus fundamentally different from those in the civil litigation system: the securities industry already has in place mechanisms fully capable of effectuating society's interest in punishing and deterring wrongdoing that might be the subject of punitive damages claims in arbitrations. And federal and state agencies are specifically charged with ensuring that securities firms and their employees do not violate applicable standards of conduct. Accordingly, the purpose underlying punitive damages does not apply here: there simply is no need to invest individual litigants with power to act as unsupervised "private attorneys general" when the SRO disciplinary and enforcement process, supplemented by government regulators, already is performing that function in a fully satisfactory manner. The case is in this respect just like *INS* v. *Lopez-Mendoza*, 468 U.S. 1032 (1984), which held that application of the exclusionary rule in deportation proceedings was not justified because of existence of a meaningful administrative disciplinary regime.

Indeed, because the SRO disciplinary process is funded in significant part by the fines collected in disciplinary

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[13] See, *e.g.*, Ariz. Rev. Stat. Ann. §§ 44-1961 to 44-1962, 44-1991, 44-1995, 44-2036 to 44-2037 (1994); Colo. Rev. Stat. §§ 11-51-410 to 11-51-501, 11-51-601 to 11-51-603 (1994); Vt. Stat. Ann. tit. 9, §§ 4221a, 4224a-4225a (1994).



proceedings, and fairness would require those fines to be diminished or abated to reflect penalties already imposed on defendants by arbitrators, the injection of punitive damages into securities arbitration would actually *undermine* the goal of rational, fair, and effective deterrence of wrongdoing.

### 3. The Contract Provision Is Not Unconscionable.

Petitioners (Br. 58-69) and their private amici (PIABA Br. 23-32; American Ass'n of Limited Partners (AALP) Br. 21-28) contend that if the contract bars the award of punitive damages in arbitration, it is unconscionable. They advance a bewildering array of charges in support of that proposition. All of them are meritless.

To begin with, petitioners' unconscionability argument necessarily rests on state law. Their claim for punitive damages arises solely under state law; the federal securities laws do not provide for awards of punitive damages (see 15 U.S.C. § 78bb(a)).[14] The question whether public policy invalidates an agreement barring punitive damages awards accordingly must be answered by reference to state law.[15] Insofar as petitioners' claim is that the entire contract is unconscionable, that issue too is one of state law. Neither petitioners nor their amici discuss state-law unconscionability standards or explain why this Court should address these state-law issues. Moreover, the factors that petitioners and the amici cite to justify their conclusion are utterly unconvincing.

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[14] Thus, petitioners' reliance (Br. 59) on the "federal goal of investor protection" is entirely misplaced.

[15] For that reason, petitioners' citation (Br. 67-68) of this Court's statement in *Mitsubishi Motors* regarding federal statutory claims is inapposite.

First, petitioners argue (Br. 60) that the effectiveness of their "waiver" of punitive damages must be evaluated under the "intentional relinquishment or abandonment of a known right or privilege" standard established in *Johnson* v. *Zerbst*, 304 U.S. 458, 464 (1938). See also PIABA Br. 30-31; AALP Br. 21. While that standard may govern some waivers of constitutional rights, we know of no case invoking it to measure the validity of a commercial contract between private parties, and petitioners have cited none. Given the many circumstances in which contract provisions are interpreted to apply to unforeseen circumstances, petitioners' approach would effect a substantial reordering of basic principles of contract law.[16]

Petitioners' argument also depends on the existence of a "right" to punitive damages. But petitioners have no such right. Punitive damages "'are not compensation for injury. Instead, they are private fines levied * * * to punish reprehensible conduct and to deter its future occurrence.'" *Electrical Workers* v. *Foust*, 442 U.S. 42, 48 (1979) (citation omitted). They are thus "a windfall to a fully compensated plaintiff," not a sum to which he or she has an entitlement by virtue of a status as an injured party. *City of Newport* v. *Fact Concerts, Inc.*, 453 U.S. 247, 267 (1981). "So far is this opportunity [to recover punitive damages] from being a fundamental personal right that it is an interest not truly personal in nature at all. It is rather a public interest * * *." *In re Paris Air Crash*, 622 F.2d 1315, 1319-1320 (9th Cir.) (Kennedy, J.), cert. denied, 449 U.S. 976.

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[16] Petitioners' argument rings hollow in view of the fact that at the time they entered into the agreement, industry members had clearly staked out the position that the choice-of-New-York-law clause barred imposition of punitive damages. See, *e.g.*, *Pierson* v. *Dean Witter Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984) (holding punitive damages barred by choice-of-law clause).



Third, PIABA suggests (Br. 25-26) that the securities arbitration system is tilted in favor of the securities industry. This is a wholly unfounded assertion. In reality, impartial studies show that claimants prevail *more often* than defendants (see page 3, *supra*). Thus, the General Accounting Office's "analysis of statistical results of decisions in arbitration cases at both industry-sponsored and independent forums showed no indication of a pro-industry bias in decisions at industry-sponsored forums." GAO, *supra*, at 6.

Finally, petitioners' entire argument ignores the fact that the arbitration process — and the customer contracts incorporating agreements to arbitrate — are closely supervised by the statutory self-regulatory organizations and the SEC. As this Court has observed, the Securities and Exchange Commission "has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes." *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 233-234 (1987). See also SEC Am. Br. at 13, *Shearson/American Express Inc.* v. *McMahon*, *supra* ("the Commission has had the power to ensure that the arbitration procedures prescribed by the SROs are adequate to enforce the rights of customers against brokerage firms that are members of the SROs"). Those expert bodies have approved the arbitration process now in place. That imprimatur is dispositive of petitioners' public policy arguments. Cf. *McMahon*, 482 U.S. at 234 ("[w]e conclude that where, as in this case, the prescribed procedures are subject to the Commission's * * * authority, an arbitration agreement does not effect a waiver of the protections of the Act").[17]

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[17] Since this Court's decision in *McMahon*, moreover, the arbitration process has been revised to incorporate still more procedural protections for claimants. See, *e.g.*, NASD Code of Arbitration Procedure §§ 19(c) (definition of "industry" arbitrator amended to ensure that even individuals with a remote connection to the securities industry are not named as "public" representatives

### C. NASD Rule 21(f)(4) Does Not Override Contractual Choice-of-Law Provisions.

Petitioners (Br. 56-57) and their amici (U.S. Br. 10; AALP Br. 4; PIABA Br. 28) cite NASD Rule of Fair Practice 21(f)(4), arguing that it is somehow relevant to the dispute in this case (or, in the case of the United States and the SEC (Br. 7, 12) that its meaning should be ruled upon even if it is not applicable to the current dispute). As the government acknowledges (Br. 12), however, that rule by its terms applies only to contracts entered into after September 7, 1989 (see NASD Rule of Fair Practice 21(f)(5)) and therefore has no relevance to this case because petitioners' contract was signed in 1985. Pet. App. 2-3. Moreover, petitioners and the amici are wrong in their view that, if applicable, the rule would override the effect of the parties' choice of New York law on the availability of punitive damages.

#### 1. Petitioners' Construction Makes No Sense And Is Inconsistent With The Rule's History.

The relevant portion of Rule 21(f)(4) states that an arbitration agreement may not include "any condition which * * * limits the ability of the arbitrators to make any award." Read literally, as petitioners do, the rule would prohibit all choice-of-law clauses, because such clauses necessarily limit the arbitrator's authority by mandating the application of one State's law. If an arbitration agreement references New York law, that law must apply, even if the claimant otherwise could have argued for the application of, for example, more favorable Texas law. Petitioners' reading of the rule, however, would require arbitrators to apply the law most favorable to the claimant on every issue.

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on arbitration panels); 23(a) (arbitrators must disclose past or current relationships with parties); 32-33 (pre-hearing discovery expanded); 41 (enhanced availability of arbitration results).



NASD did not intend to forbid the use of a clause that appears in almost every arbitration agreement. Indeed, securities firms continue to include choice-of-law clauses in their customer agreements and the NASD has never taken any action to bar that well-settled practice. The rule permits choice-of-law clauses and bars only contract provisions that expressly limit an arbitrator's authority — for example, by imposing time limits for filing claims or fixing an upper limit on potential damages awards, even though applicable state law would not do so.

Indeed, the SEC Release approving adoption of the rule is consistent with this view; it states only that "[i]f punitive damages * * * would be available under *applicable law*, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them." 54 Fed. Reg. 21144, 21154 (1989) (emphasis added). See also NASD Notice to Members 88-87 at 2 (Nov. 1988) (describing Rule 21(f)(4) as barring contract conditions that would "limit[] the ability of an arbitrator * * * to make [a punitive] award under [SRO] rules *and applicable law*") (emphasis added). Where there is a choice-of-law clause, that provision supplies the "applicable law." Thus, the rule does not bar the operation of clauses such as the one present in the agreement in this case.[18]

Moreover, this rule was adopted at a time when a number of NASD members were engaged in litigation

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[18] The SEC relies (Br. 10) on language in its release stating that "[a]greements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum." But the agency's construction of that sentence suffers from the same problem as petitioners' interpretation of the plain language of the rule: it would bar choice-of-law clauses altogether, because such clauses eliminate a party's right to invoke the law of various jurisdictions. That sentence is most logically interpreted by reference to the next one, which — as noted in the text above — expressly preserves choice-of-law clauses.

concerning availability of punitive damages in arbitration. It is inconceivable that this contentious issue — which produced numerous published decisions and law review articles during the very period the rule was under consideration — was resolved *sub silentio* by the NASD's adoption of this rule.

The history of rulemaking in this area confirms this conclusion. Shortly after the Second Circuit's 1991 decision in *Barbier* holding that the New York choice-of-law provision bars awards of punitive damages, the Securities Industry Conference on Arbitration (SICA) amended its uniform rules to add the following provision:

> The arbitrator(s) may grant any remedy or relief that the arbitrator(s) deem just and equitable and that would have been available in a court with jurisdiction over the matter.

Uniform Code of Arbitration § 28(h). This new provision obviously would not have been necessary if Rule 21(f)(4) — adopted by SICA several years earlier — had the meaning ascribed to it by petitioners. On that view, Section 28(h) would be entirely superfluous because Rule 21(f)(4) already fulfilled that purpose. SICA's decision to adopt Section 28(h), together with the fact that Section 28(h) is one of the few provisions of the Uniform Code of Arbitration that has *not* been adopted by the NASD and other SROs, provides conclusive evidence that Rule 21(f)(4) does not override choice-of-law clauses.

Indeed, in connection with a change in NASD rules making it clearer that arbitrators may, in conjunction with or in lieu of an award of punitive damages, refer matters for a disciplinary investigation, the SEC noted that the NASD was "not expressing any official position with respect to the ability of arbitrators to award punitive damages." 59 Fed. Reg. 36242, 36243 n.7 (1994). The NASD — which, after all, is the best source regarding the meaning of its own rules — obviously would not have included that caveat if it had



definitively resolved the issue when it promulgated Rule 21(f)(4). The rule simply does not have the broad meaning attributed to it by petitioners.

### 2. Petitioners' Interpretation Of The Rule, If Adopted, Would Raise Serious Questions About The Constitutionality Of The Current Arbitration System.

If petitioners were correct about the meaning of Rule 21(f)(4), the forced subjection of defendants to punitive damages exposure in securities arbitration would raise the fairness concerns discussed above (see pages 13-18, *supra*) to the level of a due process violation. That fact weighs strongly against petitioners' interpretation of the rule.

Although the rule was adopted by the NASD rather than the SEC, there is governmental involvement sufficient to trigger application of the due process requirement. First, federal law requires that broker-dealers be members of the NASD, and thus subject to NASD arbitration provisions. See page 19, *supra*. The government may not compel membership in an organization whose rules would violate the Constitution if imposed directly by the government. In *Keller* v. *State Bar of California*, 496 U.S. 1, 11 (1990), for example, the Court stated that even though the state bar association was "a good deal different from most other entities that would be regarded in common parlance as 'governmental agencies,'" its rules were subject to First Amendment constraints because "all * * * lawyers admitted to practice in the State must be members."

Similarly, in the labor area, the Court has found constitutional limitations applicable to union activity where a statute either requires employees to be members of a union or authorizes unions and employers to agree that non-union employees would make payments to a union in lieu of dues. See, *e.g.*, *Abood* v. *Detroit Board of Education*, 431 U.S. 209 (1977); *Railway Employees' Dept.* v. *Hanson*, 351 U.S.

225 (1956). In *Moose Lodge No. 107* v. *Irvis*, 407 U.S. 163 (1972), the Court found that racially discriminatory by-laws of a private organization became imbued with governmental action by virtue of a requirement of state law that the organization adhere to its own by-laws. As the Court explained (*id.* at 178-179):

> Even though the Liquor Control Board regulation in question is neutral in its terms, the result of its application in a case where the constitution and by-laws of a club required racial discrimination would be to invoke the sanctions of the State to enforce a concededly discriminatory private rule. * * * [T]he application of state sanctions to enforce such a rule would violate the Fourteenth Amendment.

The compulsory membership provision in the federal securities laws binds NASD members to the arbitration procedures adopted by the NASD in the same way the lawyers and union members were obligated to comply with the rules of their state bar association and their unions. These decisions therefore provide especially strong support for the application of due process standards to the NASD arbitration system.[19]

That conclusion is bolstered by special considerations relating to punitive damages. The imposition of sanctions to punish and deter misconduct — which are the purposes of

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[19] This argument is substantially reinforced by the nature of the government's involvement here. In addition to the statutory requirement that broker-dealers be members of the NASD, the SEC is given sweeping authority over the NASD, including the power to amend NASD rules to ensure the fair administration of the Association or further the purposes of the securities laws. See 15 U.S.C. § 78s(b) & (c). This highly unusual grant of plenary authority to the Commission enhances the government's involvement in and responsibility for the NASD's rules.



punitive damages — is, like criminal law, within the traditional and exclusive province of the state.[20] That the function at issue has been "'traditionally the exclusive prerogative'" of the government[21] is an additional important consideration supporting the application of due process standards to the procedure for awarding punitive damages in arbitration.

For the foregoing reasons, the due process requirements set forth in Court's decisions in *Honda Motor Co.* and *Haslip* apply with full force to NASD arbitration proceedings in which punitive damages are sought. As in the judicial system, imposition of punishment in an arbitration process in which NASD members are forced to participate poses "an acute danger of arbitrary deprivation of property." *Honda*, 114 S. Ct. at 2340.

Any punitive award accordingly would have to be subject to independent review by a court, pursuant to the decision in *Honda*, together with the other procedural protections outlined above. See pages 16-18, *supra*. Because those protections are not present in the current system, an award of punitive damages would violate the Constitution. Rather than construing the rule in a manner that renders it unconstitution-

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[20] *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793, 796 (N.Y. 1976) ("[p]unitive damages is a sanction reserved to the State"). See also *Edmonson* v. *Leesville Concrete Co.*, 500 U.S. 614, 625 (1991) (in civil punitive-damages cases, "the jury can weigh the gravity of a wrong and determine the degree of the government's interest in punishing and deterring willful misconduct. * * * [This is a] traditional function[] of government"); *Georgia* v. *McCollum*, 112 S. Ct. 2348, 2355 (1992) ("the selection of a jury in a criminal case fulfills a unique and constitutionally compelled governmental function").

[21] *San Francisco Arts & Athletics* v. *United States Olympic Comm.*, 483 U.S. 522, 544 (1987) (emphasis omitted).

al, it is appropriate to interpret it to avoid casting a doubt on the arbitration process.

## CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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